Chinese state-owned banks have come a long way. With the recent IPO of the Agricultural Bank of China, all of China’s “big four” state-owned banks are now publicly traded on the Hong Kong Stock Exchange. Today, these state-owned banks are among the world’s largest commercial banks in terms of total market value. The Industrial and Commercial Bank of China (ICBC), for example, is the world’s largest bank, with about a US$253 billion market capitalization. Not only are Chinese banks big, they are also very profitable; ICBC made a profit of US$19 billion last year.

Initially set up under the treasury department in China’s socialist-era economy, the “big four” originally served as funding channels for the central government. Each targeted a specific area of the economy, and was named accordingly. For example, the Agricultural Bank of China is focused on providing loans to rural areas.

The four state-owned banks dominated China’s banking sector, especially during the 1990s (accounting for 78% of all banking assets in 1993) when other financial institutions, such as regional banks, were still underdeveloped. However, banks were operating under a climate of rigid socialism, making them very inefficient with low profitability.

The Old Days
During the early 1990s, I worked at the Guangdong branch of the Bank of China, and witnessed how a typical state-owned bank operated during those days. I still remember the first technical term that I learned as a junior loan officer. It was “zhan qi,” which in Chinese means “roll over.” It seemed that the only thing the loan department was doing those days was rolling over expired loans. Loan quotas were decided early in the year by the planning department based on government guidance over which sectors and industries should be supported. The loan department merely allocated loans and, if the principle was ultimately uncollected, it would roll the loans over to the next period. There was little emphasis on banking profitability and just as little due diligence to analyze the quality of the companies receiving loans. Although no official data is available for state-owned banks during that period, it is widely estimated that the average nonperforming loan ratio was as high as about 30% to 35%.
China’s banking reform has effectively transformed its state-owned banks into commercial banks running under international practices.

The Reform
China’s banking sector reform began in the mid-1990s. The reform was intended to restructure the state-owned entities from traditional socialist banks into more market-oriented banks that prioritized profitability and minority shareholder rights.

The first step in reform was to unburden state-owned banks from policy-related loans. To this end, three different policy banks were set up: the China Development Bank, the Export-Import Bank of China and the Agricultural Development Bank of China. These policy banks served the traditional role of funding government-supported areas in which the state-owned banks once focused. The state-owned banks were then freed up to conduct business with less government influence.

The next step in the reform involved solving the historical problem of mounting nonperforming loans that accumulated throughout the state-owned banking system. Two things were done in this area. First, the government directly injected funds to recapitalize the banks with a total of US$32.5 billion in March 1998. Second, asset management companies were set up to take over the nonperforming loan assets directly from the banks. Each of the “big four” banks now have a separate asset management firm to deal with the bad loans. Since 1999, these four asset management firms removed a total of US$168 billion of nonperforming loans from the state-owned banks, helping them gain much stronger footing.

China’s entry into the World Trade Organization (WTO) in 2001 was the next big push for the country’s bank reform. Under the WTO agreement, China was required to fully open its banking sector to foreign competition by the end of 2006. This set a firm deadline for the state-owned banks to actively restructure in line with international standards and run as true commercial banks that are able to compete with foreign counterparts. Chinese banks actively seek international partners to help strengthen management capabilities, and since 2005, foreign banks have invested or committed to invest over US$19 billion in China’s large state-owned banks. For example, The Royal Bank of Scotland has invested in the Bank of China and Goldman Sachs invests in ICBC. The strategic investment of foreign institutions has greatly helped enhance Chinese banks in the areas of risk management, investment banking, consumer banking and corporate governance.

The last step in China’s banking reform was the public listing of the state-owned banks, the first of which came in 2005. The listing of this first bank, which focused on construction-related funding, was quite successful, and over the next five years, the remaining three of the “big four” also went public. While the state still holds a majority share in these banks—more than 60% on average—government influence has been fading as it no longer mandates loan quotas to specific industries, and transparency and efficiency have been largely enhanced.

The Positive Impacts
China’s banking reform has effectively transformed its state-owned banks into commercial banks running under international practices. The result has been positive so far. The most obvious outcome is the vast improvement in asset quality. Nonperforming loans at state-owned banks have declined sharply over the past 15 years. In 2002, the earliest available date for reliable banking data (see chart below), the average nonperforming ratio was 24%. After years of reform and development, the ratio decreased to 1.6% in 2009. One of the most important reasons behind this was the government injection of capital and the role of asset management companies in removing the
bad loans. However, it is equally important that banks are now prioritizing profitability, and have become more prudent in developing businesses and controlling risks. Not only has the quality of bank assets improved, the average return on assets rose from 0.3% in 2002 to around 1.0% in 2009. In our meetings with all major banks in China, risk management, corporate governance and transparency have become common topics for discussion.

Wealth management is also a new expansion area that includes selling mutual funds and providing personal financial planning services.

Going forward, the sector still faces many risks and challenges. Among them, the potential for overheating in the property market and near-term deterioration of asset quality are areas in which we are keeping a close watch. Because China still holds a majority stake in its largest banks, and has given “guidance” to them, this control is still something to consider.

Nonetheless, Chinese state-owned banks have come a long way through various stages of reforms, and the entire banking sector is healthier because of it. While the “big four” still account for about half of all lending in the banking system, other smaller types of banks such as joint-stock banks and regional banks are also quickly developing and playing an increasingly important role. Joint-stock banks are non-state-owned and, for the most part, were developed during the reform efforts of the late 1990s to further diversify the domestic banking industry. These banks, which did not have the historical issues of the “big four,” are much healthier and have been establishing niche positions in such service areas as trade financing, retail and institutional banking. They also issue loans to small and medium enterprises. Over the years, joint-stock banks have steadily increased asset size as well as market share, mostly at the expense of state-owned banks. Overall, China’s bank reforms have generally played a positive role in the country’s economic development as banks now strive to conform to global standards while maintaining their own unique Chinese characteristics.

Richard Gao
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“Nonperforming loans at state-owned banks have declined sharply over the past 15 years.”
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